

Delaware Chancery Court Creates Potential Pitfall For Indemnification And Advancement Rights

By David W.T. Daniels

Anyone who has been involved in civil litigation or a regulatory investigation can appreciate the speed with which legal bills can add up or the costs of settlement. Directors and officers frequently are targets of civil litigants and regulators, which can be financially devastating for these individuals absent adequate protections. Most company by-laws provide directors and officers with the right to advancement (requiring the company to pay defense costs as incurred) and the right to indemnification (requiring the company to pay the cost of defense, settlement or judgment after the matter is concluded). In addition to insurance, these rights provide critical protection for directors and officers against the risk of litigation. A recent decision by the Delaware Court of Chancery, however, has created a hole in what may have appeared to be bulletproof indemnification and advancement by-law language. The decision points to the potential need for changes in by-law language or a separate agreement to prevent a company from unilaterally withdrawing such protections.

In *Schoon v. Troy Communications*, No. 2362-VCL, 2008 WL 821666 (Del. Ch. Mar. 28, 2008), a Delaware judge held that a company can amend its by-laws to eliminate advancement rights for a former director when those rights had not “vested” at the time of the claim. The *Schoon* case involved a request for advancement by an outside director, William Bohnen, who had been appointed by an investor to serve on the board of Troy Communications, a privately-held company incorporated under Delaware law.

During the time that Mr. Bohnen served on the board, the company’s by-laws provided for advancement of defense costs to current and former directors. Mr. Bohnen resigned from the board in February 2005. Subsequently, a dispute arose between the company and the investor, during the course of which the company amended its by-laws and removed advancement rights for former directors. After the change was made, the company sued Mr. Bohnen alleging that he had breached his fiduciary duty to the company while he was a director. Mr. Bohnen demanded that the company advance his defense costs in that lawsuit. The company refused, and Mr. Bohnen filed suit. *Id.* at *1-3.

The Court decided for the company, holding that, as a former director, Mr. Bohnen was not entitled to advancement under the amended by-laws. The Court distinguished an earlier case, *Salaman v. National Media Corp.*, No. 92C-01-161, 1992 WL 808095, at *6 (Del. Super. Oct. 8, 1992), that held that the right to advancement accrued at the time a claim against the company was made. The Court noted that, unlike the *Salaman* case, no claim had been filed against Mr. Bohnen when the amendment was made and no claim against him was then contemplated. The Court rejected an argument that the advancement right vested at the time that Mr. Bohnen joined the board. *Schoon*, 2008 WL 821666, at *5.

Though the *Schoon* decision arose in the context of a dispute over advancement, its reasoning appears to apply equally to indemnification rights. The decision

Memorandum

June 12, 2008

“A recent decision by the Delaware Court of Chancery . . . has created a hole in what may have appeared to be bulletproof indemnification and advancement by-law language.”

NEW YORK
WASHINGTON, DC
LONDON

www.rkollp.com

This memorandum may be considered advertising under applicable state laws.

therefore creates a risk that a company could limit or eliminate both forms of protection. For directors appointed by an outside investor, the decision could have the practical result of shifting the costs of defending a claim from the portfolio company to any investor that owes its designees a separate duty to indemnify and advance.

Outside investors and their designated directors can help protect themselves from this risk by requiring that portfolio companies obtain investor consent prior to any revisions of their by-laws. Such an arrangement, however, may still not prevent a company from terminating advancement and indemnification rights after the investment relationship ends.

To mitigate that risk more completely, investors, directors and officers should consider requiring the insertion of by-law language providing that advancement and indemnification rights vest upon joining a company and cannot be modified absent consent of the covered individuals, thus ensuring the continuation of coverage. A written advancement or indemnification agreement, whether as part of an employment contract or otherwise, serves that same purpose.

* * *

If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

Paul A. Leder

Washington, DC
202 261 2985
pleder@rkollp.com

David W.T. Daniels

Washington, DC
202 261 2967
ddaniels@rkollp.com

This memorandum is provided by Richards Kibbe & Orbe LLP for educational and information purposes only and is not intended and should not be construed as legal advice.

© 2008 Richards Kibbe & Orbe LLP, One World Financial Center, New York, NY 10281, 212.520.1800, <http://www.rkollp.com>. All rights reserved. Quotation with attribution is permitted. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please email publications@rkollp.com.